ENSafrica Tax | Interest deductibility in South Africa

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Introduction

In South Africa, interest is deductible under the Income Tax Act, 1962 (the "**Act**") whether or not the interest is capital in nature, provided the interest is incurred "in the production of income" and as part of a "trade". The Act provides for the deduction of interest amounts incurred in respect of financial liabilities against the income of certain taxpayers, including banks.

To determine the deductibility of interest incurred on a loan, it is necessary to determine whether moneys outlaid constitute expenditure incurred in the production of income, requiring a consideration of the purpose of the expenditure and what the expenditure actually effects. In making this determination, a court will assess the closeness of the connection between the expenditure and the income-earning operations of the taxpayer. The vital enquiry is the taxpayer's subjective purpose in borrowing the moneys upon which it incurs interest. If the purpose is to apply the funding to produce income that is taxable, the interest expenditure incurred ought to be deductible.

The Act does not define interest other than in section 24J, where it is defined as including the gross amount of any interest or similar finance charges. As this definition refers to "interest", the common law meaning thereof has to be established. Interest may be understood at common law as compensation payable by the borrower to the lender for the supply of credit provided by the lender to the borrower. Interest as defined may be wider than the common law concept thereof.

There have been no changes to the deductibility of interest or the interest definition following the BEPS Action 4 Report. Regarding the limitation on interest deductibility, before the BEPS Action 4 Report, transfer pricing rules require that the arm's length principle be applied to financial assistance in the same way as it is applied to any other "affected transaction".

The Act now contains a "fixed-ratio" rule. The interest deduction permitted is calculated as interest received plus an amount calculated with reference to a formula. The Act provides for a statutory ceiling for the amount of deductible interest incurred by a company in respect of certain debt categories.

Under the Act, interest incurred by a company in respect of a "hybrid debt instrument", or interest incurred in respect of "hybrid interest", is deemed to be a dividend in specie declared and paid by the company and non-deductible in the company's hands.

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Summary

Interest is deductible in terms of section 24J(2) of the Act whether or not the interest is capital in nature, provided the interest is incurred “in the production of income” and as part of a “trade”. Section 24JB of the Act provides for the deduction of interest amounts incurred in respect of financial liabilities (so recognised in terms of applicable international standards) against the income of certain taxpayers, such as banks and companies that form part of banking groups.

It is settled law in South Africa that in order to determine the deductibility of interest incurred on a loan, it is necessary to determine whether moneys outlaid constitute expenditure incurred in the production of income, which requires a consideration of (1) the purpose of the expenditure and (2) what the expenditure actually effects. In making this determination, a court will assess the closeness of the connection between the expenditure and the income-earning operations of the taxpayer. Whether moneys are borrowed for a specific identifiable purpose or more generally in order to raise floating capital for use in business, the vital enquiry is the taxpayer’s subjective purpose in borrowing the moneys upon which it incurs interest. Where the taxpayer’s purpose is to apply the funding to produce income that is taxable, the interest expenditure incurred ought to be deductible.

The Act does not define interest other than in section 24J, where it is defined as including the gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement. As this definition of interest itself refers to “interest”, the common law meaning thereof has to be established. Based on case law, interest may be understood at common law as compensation payable by the borrower to the lender for the service provided by the lender to the borrower (ie, the service of supplying credit). However, the concept of interest as defined in section 24J (referred to above) may be wider than the common law concept of interest.

As regards the limitation on interest deductibility the South African transfer pricing rules require that the arm’s length principle be applied to financial assistance (defined as including any debt, security or guarantee) in the same way as it is applied to any other “affected transaction” which is subject to the transfer pricing rules.

Section 23M of the Act now contains a “fixed-ratio” rule, which limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient of such interest. The interest deduction permitted thereunder is calculated as interest received plus an amount calculated with reference to a formula (approximately 40% of EBITDA minus taxable interest incurred in respect of other parties).

Section 23N of the Act provides for a statutory ceiling for the amount of deductible interest incurred by company in respect of certain specific categories of debt in the context of corporate reorganisation and acquisition transactions.

In respect of limitations on interest deductibility based on the recharacterisation of interest as non-deductible distributions, in terms of section 8F interest incurred by a company in respect of a “hybrid debt instrument” (as defined therein), or interest incurred by a company in respect of “hybrid interest” as provided for in section 8FA, is deemed to be a (1) dividend in specie declared and paid by the company and (2) non-deductible in the company’s hands.

Part one | General rules regarding interest deductibility

General overview

Section 24J(2) – deductibility of interest

Section 24J of the Act regulates inter alia the incurral or accrual of interest on financial instruments. It enacts the principle that interest accrues on a "yield to maturity" basis and applies to all "instruments", defined as including any interest-bearing arrangement or debt.

Section 24J (2) of the Act deals with the deductibility of interest. In particular, in terms of section 24J(2), interest is deductible whether or not the interest is seen as capital in nature.

Section 24J(2) provides that where a person is the "issuer" in relation to an instrument during any year of assessment, such person shall for purposes of the Act be deemed to have incurred an amount of interest during such year of assessment which is equal to the sum of all accrual amounts in relation to all accrual periods falling wholly or in part within such year of assessment in respect of such instrument, which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.

An "issuer" is defined as any person who has incurred interest or has any obligation to repay an amount in terms of an instrument.

Accordingly, in terms of section 24J(2) of the Act, a person (the "issuer") may deduct an amount of interest (calculated in accordance with section 24J) "from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income".

For interest to be deductible, it must thus be incurred "in the production of income" as part of a "trade".

The "trade" requirement

The term "carrying on any trade" is not defined in the Act. However, the term "trade" is widely defined in section 1 of the Act and includes inter alia every profession, trade, business, employment, calling, occupation or venture, including the letting of any property.

In *Burgess v Commissioner for Inland Revenue [1993] 2 All SA 511 (A),* the court considered whether the appellant was carrying on a trade within the meaning of the general deduction formula contained in section 11(a) read with section 23(g) of the Act. The court described the principle that "trade" should be given a wide interpretation as being "well established". Regarding the meaning of "venture", the court stated as follows:

"…although an element of risk is included in the concept of a "venture" in its ordinary meaning, I must not be taken to suggest that a scheme like the present would only constitute a "trade" if it is risky. Whether it would or not would depend on its own facts. If there is no risk involved, it might still be covered by giving an extended meaning to "venture" or by applying the rest of the definition, which is in any event not necessarily exhaustive" (our emphasis).

In *Commissioner for South African Revenue Service v Tiger Oats Ltd [2003] 2 All SA 604 (SCA) 65 SATC 281,* the court considered whether an investment holding company listed on the Johannesburg Stock Exchange was in fact carrying on a business for purposes of the application of the Regional Services Council Act 109 of 1985. In this regard, the court held, *inter alia*, that:

"in a very real commercial sense the respondent [was] ***actively involved*** in the business of its subsidiaries and associated companies and its making of investments in those companies which enabled it to be actively involved;… [the respondent was] ***not simply a passive investor*** in [its subsidiaries and associated companies], equatable with a member of the public who invest[ed] in listed shares on the stock exchange" (our emphasis).

The principles regarding "carrying on any trade" as distilled from case law can be summarised as follows: (1) the term "trade" should be given a wide interpretation, (2) the definition of "trade" is not exhaustive, (3) merely "watching over" investments does not constitute a trade – it requires something more, for example, dealing in securities, and (4) the test as to whether a taxpayer carries on a "trade" is a factual enquiry and no single set of rules can be laid down in this regard.

In practice, the South African Revenue Service ("**SARS**") generally allows the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade. This practice of SARS is set out in Practice Note No. 31 (Income Tax: Interest paid on moneys borrowed) (Government Gazette No. 16018 of 14 October 1994) ("PN31"). Although PN31 provides that the practice set out therein will be followed by SARS, PN31 is not binding in terms of South African law.

The "in the production of income" requirement

The locus classicus on when expenditure will be incurred "in the production of income" (albeit in the context of the general deduction formula in section 11(a) read with section 23(g) of the Act) is Port Elizabeth Electric Tramway Company Ltd v CIR (1936 CPD 241) where Watermeyer AJP formulated the test in terms of which the following questions need to be asked:

1) whether the purpose of the act, to which the expenditure is attached, is to produce income; and

2) whether the expenditure is linked closely enough to this act.

In respect of the first leg of the test, in accordance with, *inter alia, CIR v Allied Building Society (25 SATC 343)*, the purpose to be determined, is the dominant purpose of the taxpayer in question. In Sub-Nigel Ltd v CIR (15 STAC 381) it was established that the words "incurred in the production of the income" do not mean that before a particular item of expenditure may be deducted it must be shown that it produced any part of the income for the particular year of assessment. The important question is whether the expenditure incurred for the purpose of earning income as defined in section 1 of the Act, whether in the current or in a future year of assessment.

Section 24JB – "covered persons"

Section 24JB of the Act deals with the taxation of any profit or loss recognised by "covered persons" in the statement of comprehensive income in respect of "financial assets" and "financial liabilities".

"Covered person" is defined in section 24JB(1) and includes, inter alia, a bank, a branch of a bank or any company that forms part of a banking group as defined in section 1 of the Banks Act, 1990 ("Banks Act").

For purposes of section 24JB, the terms "financial asset" and "financial liability" are defined as a financial asset / liability defined in and within the scope of International Accounting Standard ("IAS") 32 of International Financial Reporting Standards ("**IFRS**") or any other International Accounting Standard that replaces IAS 32.

In terms of section 24JB(2) (subject to inter alia section 24JB(4)), there must be included in or **deducted from the income of any covered person** for any year of assessment all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are measured at fair value in profit or loss in terms of IFRS 9, excluding certain specified amounts (such as amounts in respect of a dividend or foreign dividend received by or accrued to a covered person).

The essential elements in order for section 24JB(2) to find application (thus permitting a deduction against the taxpayer's income) are: (1) the taxpayer must constitute a "covered person"; (2) the relevant amounts are in respect of a "financial liability" or a "financial asset"; (3) amounts in respect of the "financial liability" or a "financial asset" are recognised in profit or loss in the covered person's statement of comprehensive income; and (4) that "financial liability" or "financial asset" is recognised in profit or loss of the covered person in terms of IFRS 9.

As set out above, section 24JB(2) is subject to the application of the section 24JB(4). Section 24JB(4) contains an anti tax-avoidance provision and states that 24JB(2) does not apply to any amount in respect of a financial asset or financial liability of a covered person where:

"a) a covered person and another person that is not a covered person, are parties to an agreement in respect of a financial asset or financial liability; and

b) the agreement contemplated in paragraph (a) was entered into solely or mainly for the purpose of a reduction, postponement or avoidance of any liability for tax, which, but for that agreement, would have been or would become payable by the covered person" (our emphasis added).

Provided all the requirements for the application of section 24JB(2) are met, the fair value movements arising in respect of a "financial liability" or "financial asset" would be included in or deducted from the income of the covered person.

Section 24JB(2A) further requires a covered person to include in or deduct from income for a year of assessment a realised gain or realised loss that is recognised in a statement of other comprehensive income as contemplated in IFRS if that realised gain or realised loss is attributable to a change in the credit risk of the financial liability as contemplated in IFRS and the instrument giving rise to that financial liability was issued in any year of assessment commencing on or after 1 January 2018.

Section 24JB(3) provides that any amount to be taken into account in determining the taxable income of a person in terms of any provision of Part 1 of Chapter II of the Act (normal tax), or in determining any assessed capital loss of a covered person in respect of a financial asset or a financial liability contemplated in section 24JB(2), must only be taken into account in terms of section 24JB.

Taxation of interest in the hands of non-resident lenders

Normal tax

South Africa taxes non-residents on all their South African sourced income

In respect of the source of interest, section 9(2)(b)(i) of the Act provides that an amount is received by or accrues to a person from a source within South Africa if that amount constitutes interest as defined in section 24J(1) where that interest is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a permanent establishment which is situated outside South Africa. In terms of section 9(2)(b)(ii), interest is also sourced in South Africa if the relevant (loan) funds are utilised or applied in South Africa. Section 9(4)(b) provides that an amount is received by or accrues to a person from a source **outside** South Africa if it is received by or accrued to that person from a source that is **not** within South Africa in terms of section 9(2)(b).

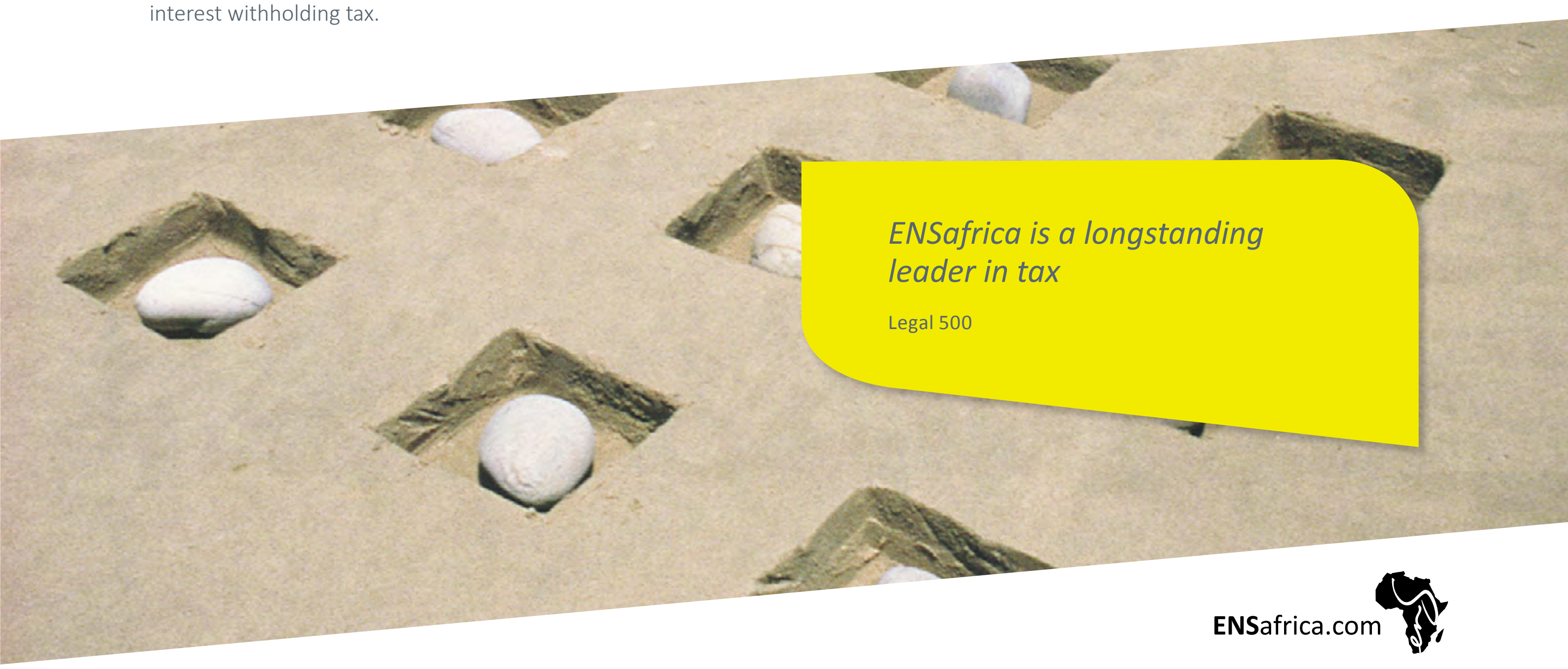
Section 10(1)(h) of the Act provides that an amount of interest which is received by or accrues to a person that is not a resident is exempt from normal tax in South Africa, unless (i) the person is a natural person who was physically present in South Africa for a period exceeding 183 days in aggregate during the 12 month period preceding the date on which the interest is received or accrued by or to the person, or (ii) the debt from which the interest arises is effectively connected to a permanent establishment of the person in South Africa.

Interest withholding tax

Section 50B(1) of the Act provides that there must be levied a tax known as the withholding tax on interest, calculated at a rate of 20% of the amount of any interest that is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within South Africa in terms of section 9(2)(b) of the Act. Section 50E(1), subject to sections 50E(2) and 50E(3), places a withholding obligation on any person who makes payment of any amount of interest to or for the benefit of a foreign person. The interest withholding tax is a final tax.

In terms of section 50B(2), interest is deemed to be paid on the earlier of the date on which the interest is paid or becomes due and payable. For purposes of the interest withholding tax, "interest" is defined in section 50A(1) as interest as contemplated in paragraph (a) or (b) of the definition of "interest" in section 24J(1) (see below).

There are a number of exemptions from the interest withholding tax under South African domestic law. In terms of section 50D, an amount of interest paid to a foreign person by inter alia any bank (as defined in the Banks Act), in respect of listed debt or by an entity in circumstances where the interest is subject to normal tax in South Africa will be exempt from the interest withholding tax.



Definition of “interest”

The Act does not define “interest” other than in section 24J of the Act.

Section 24J(1) defines “interest” as including the:

“(a) gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

(b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation of any amount to which the lender would, but for such lending arrangement have been entitled; and

(c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is party, irrespective of whether such amount is –

(i) calculated with reference to a fixed rate of interest or variable rate of interest; or

(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement”.

Juta’s Commentary on Income Tax (Online Version, 2015 update) (“Juta”) states the following with regard to paragraph (a) of the definition of “interest” in section 24J(1) of the Act:

> “As the definition of interest itself refers to ‘interest’, the common law meaning of interest, which is uncertain, has to be established.”

Our courts have considered the meaning of common law interest on a number of occasions.

In ***Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd 1946 AD 441 (“Lever Brothers”)***, Watermeyer CJ made the following statement in a majority judgment of the Appellate Division (as it then was):

> “As a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest...Although, colloquially, one speaks of a debt carrying interest, or interest on a debt, as though interest were a sort of growth sprouting from the debt, the language used means no more than that the borrower pays interest, if that is the agreement between the borrower and lender, as consideration for the benefits allowed to him by the lender”.

According to the majority judgment in ***Lever Brothers***, common law interest can therefore be construed as compensation payable by the borrower to the lender for the service provided by the lender to the borrower, which service is the supply of credit by the lender to the borrower.

This is echoed in Silke on South African Income Tax (Online version) ("Silke"), at paragraph 17.63, where the authors state that interest "*[i]n its ordinary connotation is consideration for the use of money*". In respect of the decision of the Supreme Court of Appeal ("SCA") in ***Cactus Investments (Pty) Ltd v CIR 1999 1 All SA 345 (A)*** the authors of Juta note the following:

"In [Cactus Investments] the Supreme Court of Appeal held that this definition [i.e. interest defined as compensation for the use of money] cannot always be applicable, but that in some instances interest can be regarded as the return an investor expects for his or her investment. If the latter interpretation is correct, it will be very difficult, if not impossible, to argue that an amount received in addition to the repayment of the capital amount is not interest."

In addition, section 8FA of the Act deals with the taxation of "hybrid interest". In this regard "hybrid interest" in relation to any debt owed by a company in terms of an instrument means, inter alia, any interest where the amount of that interest is not determined with reference to a specified rate of interest or not determined with reference to the time value of money.

"Interest" is defined in section 8FA(1) as meaning "interest" as defined in section 24J(1). This implies that the concept of "interest" as contemplated in paragraph (a) of the definition of "interest" in section 24J(1) may include "hybrid interest" as defined in section 8FA(1) of the Act.

As noted above, "hybrid interest" in relation to any debt owed by a company in terms of an instrument means, ***inter alia***, any interest where the amount of that interest is (1) not determined with reference to a specified rate of interest, or (2) not determined with reference to the time value of money.

Based on the above, the concept of "interest" in paragraph (a) of the definition of "interest" in section 24J(1) may therefore be wider than the common law concept of interest.

Specific comments on interest deductibility

The principles upon which to determine the deductibility of interest incurred on loan funding have been largely established and set out in South African tax case law. These are summarised in 1.1 above.

It is settled law in South Africa, that generally, in order to determine the deductibility of interest incurred on a loan in a particular case, it is necessary to examine whether the moneys outlaid by the taxpayer constitute expenditure incurred in the production of the taxpayer's income. Important, and sometimes overriding factors which are relevant in this regard, are: (1) the purpose of the expenditure and (2) what the expenditure actually effects.

In making this determination, a court has to assess the closeness of the connection between the expenditure and the income-earning operations of the taxpayer (see CIR v Standard Bank of SA Ltd 1985 4 SA 428 (A)).

Original purpose of a loan

Where a taxpayer originally acquires funding in order to finance income-producing operations, and subsequently applies those same funds in an asset which does not produce income, or acquires additional funding in order to refinance its original loan obligation, the original purpose for which that funding was acquired (i.e. where that original purpose was to fund income-producing operations) will operate to ensure that the interest incurred on the funding (or refinancing, as the case may be) remains deductible (refer ***Producer v Commissioner of Taxes 1948 4 SA 230 (SR) 15 SATC 45; Special Board Decision No 125 1999 4 SASBDR 75; ITC 1553 1989 55 SATC 105).***

General or specific purpose

In the case, *CIR v Standard Bank of SA Ltd 1985 4 SA 428 (A)*, the then South African Appellate Division (now the SCA), held that in determining whether interest incurred by a taxpayer in respect of moneys borrowed for use in its business is deductible, a distinction may be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose (a "specific purpose"), and the case where the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in its business (a "general purpose").

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In the former type of case, where money is borrowed for a specific purpose, both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close causal connection can be traced. Both the aforementioned factors are, therefore, important considerations in determining the deductibility of such interest expenditure.

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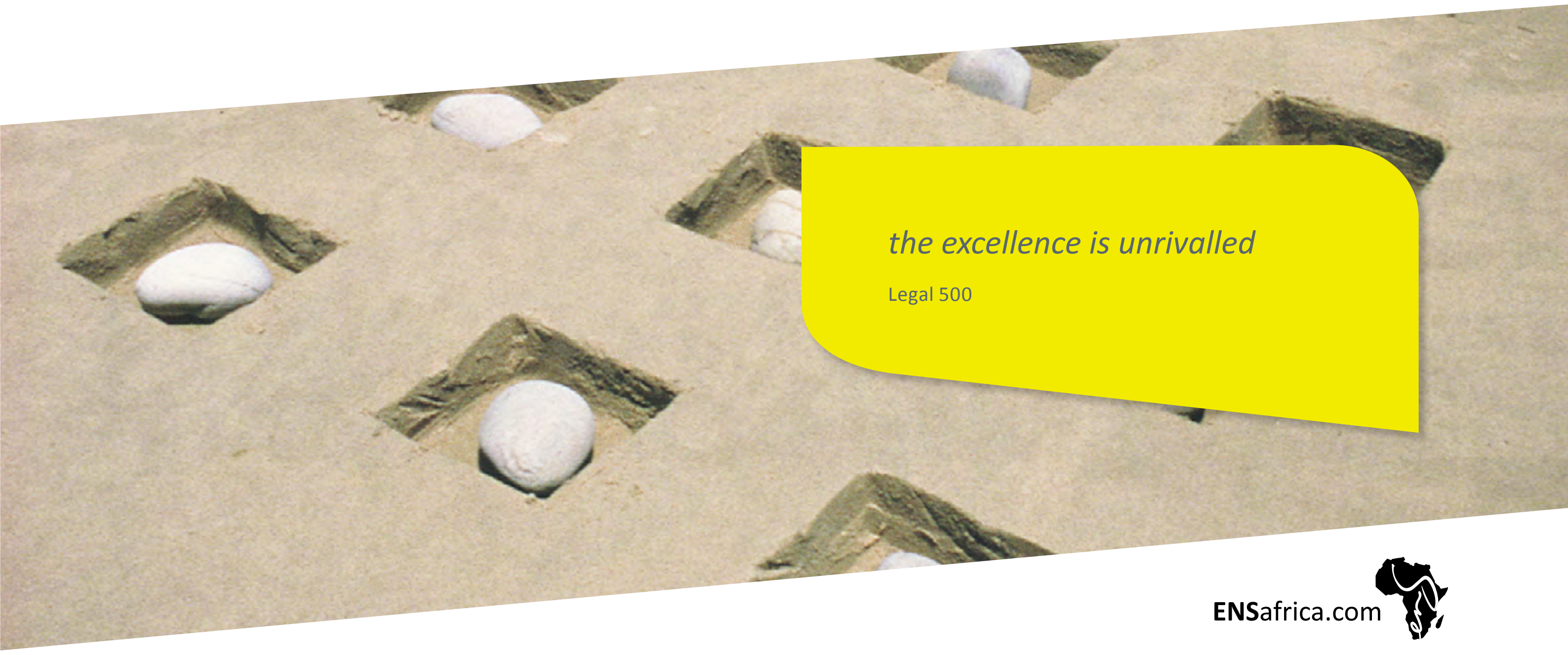
In the latter type of case, however, where money is borrowed for a general purpose, there are certain factors which prevent the identification of such a causal connection, making it factually impossible to link the interest incurred with the manner in which the capital is used. In the Standard Bank case, the court held that all that one can say is that in a general sense, such expenditure is incurred in order to provide the taxpayer with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised.

In such instances, therefore, the ultimate use or destination of the money borrowed by the taxpayer should not, on the facts of that case, be elevated into a decisive factor in determining the deductibility of the interest payable on that loan. The "vital enquiry" in such instances, as per the decision in the Standard Bank case, is the taxpayer's purpose in borrowing the moneys upon which it paid interest. Where the taxpayer's purpose was to apply the funding to produce income, the interest expenditure incurred ought to be deductible.

Although the test of purpose is a subjective and factual test, regard must also be had to the relevant facts and circumstances of a matter. While purpose is primarily a subjective test, South African courts will not merely accept the "say so" of the relevant party, but will test this against the surrounding facts and circumstances (refer ***Commissioner for Inland Revenue v Pick 'n Pay Wholesalers (Pty) Ltd 49 SATC 132).***



General overview

Transfer pricing rules – thin capitalisation

Section 31 of the Act contains the provisions relating to the South African transfer pricing rules. The South African transfer pricing rules will apply, broadly speaking, to any transaction, operation, scheme, agreement or understanding where (1) that transaction constitutes an "affected transaction" as defined, and (2) results or will result in any tax benefit being derived by a person that is a party to the affected transaction.

> "Affected transaction" is defined in section 31(1) and includes, inter alia, any transaction, operation, scheme, agreement or understanding which has been directly or indirectly entered into or effected between or for the benefit of either or both, inter alia, a resident and a non-resident which are "connected persons" (as defined in the Act) in respect to each other and where any of the terms or conditions agreed upon are not of an arm's length nature.

Section 31(2) of the Act places an obligation on each party to the affected transaction which derives a tax benefit, to calculate its taxable income or tax payable as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed, had those persons been independent persons dealing at arm's length.

With the introduction of the current South African transfer pricing rules (which came in effect on 1 April 2012), thin capitalisation forms part of the general transfer pricing mandate (in alignment with the view of the Organisation for Economic Co-operation and Development ("**OECD**")). The South African transfer pricing rules require that the arm's length principle be applied to "financial assistance" in the same way as it is applied to any other transaction, operation, scheme, agreement or understanding. "Financial assistance" is defined as including any debt, security or guarantee.

In practice, in the context of financial assistance, a taxpayer is required to determine, inter alia, (1) what amounts it would and could have been able to borrow in the open market (i.e. its lending capacity), (2) on what overall terms and conditions, and (3) at what price.

SARS has issued a draft interpretation note ("Determination of the Taxable Income of certain persons from international transactions: Thin Capitalisation") which is yet to be finalised. SARS states therein that, in order to consider what constitutes an appropriate amount of debt for thin capitalisation purposes, and in applying the arm's length principle to funding arrangements, a taxpayer should consider the transaction from both the lender's perspective and the borrower's perspective.

That is, in determining the arm's length amount of debt from the lender's perspective, whether the amount borrowed could have been borrowed at arm's length (i.e. what a lender would have been prepared to lend and therefore what a borrower could have borrowed), and from the borrower's perspective, whether the amount would have been borrowed at arm's length (i.e. what a borrower acting in the best interests of its business would have borrowed). In addition, the taxpayer needs to consider whether the interest rate constitutes an arm's length interest rate.

It should be noted that SARS' interpretation notes are not law, but provide insight into the prevailing practice of SARS and guidance on SARS' views on the interpretation and application of provisions of tax Acts.

Section 23M – limitation of interest deductions on debts owed to person not subject to tax

Section 23M of the Act contains a "fixed-ratio" rule. For section 23M to apply, the following requirements must be present: (1) the debtor must be a South African resident for tax purposes, (2) the debtor and the creditor must be in a controlling relationship, or, where the creditor is not in a controlling relationship to the debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor, and (3) the interest incurred must not be subject to tax in the hands of the person to whom it accrues during that year of assessment.

Section 23M(1) defines "controlling relationship" as a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person. "Interest" in terms of section 23M means "interest" as defined in section 24J of the Act (see above).

The term "tax" is defined in section 1 of the Tax Administration Act, 2011 ("TAA") as including a tax, duty, levy, royalty, fee, contribution, penalty, interest and any other moneys imposed under a tax Act. Section 1 of the Act defines "tax" as a tax or penalty imposed in terms of the Act. Irrespective of the definition followed, if the interest is subject to either the normal (income) tax or the withholding tax on interest, the interest deduction will not be limited in the hands of the debtor.

The words "subject to tax" are not defined in the Act. In our view, notwithstanding that an amount of interest may, for example, constitute "gross income", it should not be regarded as being subject to tax if it is exempt from tax.

Section 23M(3) provides that the amount of interest allowed to be deducted in respect of all debts owed as contemplated in section 23M(2), in respect of any year of assessment must not exceed the sum of:

1) the amount of interest received by or accrued to the debtor; and
2) a percentage of that adjusted taxable income of that debtor to be determined in accordance with the formula –

$$A = B \times C/D$$

In which formula –
"A" represents the percentage to be determined;
"B" represents the number 40;
"C" represents the average repo rate plus 400 basis points; and
"D" represents the number 10,
but not exceeding 60 per cent of the adjusted taxable income of that debtor,

reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in section 23M(2) as exceeds any amount not allowed to be deducted in terms of section 23N (refer below).

"Repo rate" is defined as the interest rate at which the South African Reserve Bank ("SARB") enters into a repurchase agreement envisaged in s 10(1)(j) of the SARB Act, 90 of 1989. According to Silke at paragraph 13.39B, "this is the official rate of interest at which the SARB lends or discounts eligible paper for deposit money banks, typically shown on an end-of-period basis". The term "average repo rate" in relation to a year of assessment is defined as the average of all ruling repo rates determined by using the daily repo rates during that year of assessment.

Silke states the following at paragraph 13.39A in respect of section 23M:

> "In essence, the provision limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient. Briefly stated, the interest deduction allowed is calculated as interest received plus an amount calculated with reference to a formula, about 40% of EBITDA minus taxable interest incurred in respect of other parties. Even though the limitation of interest deductions in terms of s 23M could in many instances have the same effect as a thin capitalisation adjustment, the interaction between s 23M and s 31...is not clear" (our emphasis).

As such, in terms of section 23M, net interest expenses in respect of certain inbound loans may be disallowed as a deduction to the extent that they exceed a specified percentage of a resident taxpayer's EBITDA. The percentage of EBITDA to be applied depends on the prevailing base lending rate, but is currently 40%.

Where an amount of interest is to be taken into account under section 23M and under section 23N (refer below), that amount of interest shall only be taken into account under section 23M after section 23N has been applied.

Section 23M does not apply to so much of the interest incurred by a debtor in respect of a debt owed to a creditor as contemplated in section 23M(2) where: (1) that creditor funded that debt amount advanced to that debtor with funding granted by a lending institution that is not in a controlling relationship with that debtor and (2) that interest is determined with reference to a rate of interest that does not exceed the official rate of interest plus 100 basis points.

Section 23N – Limitation of interest in respect of reorganisation and acquisition transactions

Section 23N(2) of the Act provides that where an amount of interest is incurred by an acquiring company in terms of a debt:

a) directly or indirectly assumed or applied for the purpose of procuring, enabling, facilitating or funding the acquisition by that acquiring company of any asset in terms of a reorganisation transaction;

b) used directly or for the purpose of redeeming, refinancing or settling the debt contemplated in a) above;

c) issued, assumed or used in terms of an acquisition transaction; or

d) used directly or indirectly for the purpose of redeeming, refinancing or settling the debt contemplated in c) above,

the amount of interest allowed to be deducted must not exceed the amount determined in accordance with section 23N(3) (refer below).

Silke states the following at paragraph 13.39B in respect of section 23N (footnotes omitted):

> "Section 23N reflects the intent on the part of the legislature to ensure that, in transactions relating to corporate reorganisation and acquisition, excessive debt is not used to achieve tax savings that are central to the viability of the deal. It establishes an objective test – a statutory ceiling in respect of the amount of deductible interest incurred by an acquiring company in relation to specified categories of debt. If a taxpayer meets the qualifying criteria, the interest incurred is tax deductible, subject to the stipulated deductibility thresholds..." (our emphasis).

“Interest” under section 23N means “interest” as defined in section 24J.

An “acquiring company” is defined as a transferee company contemplated in the definition of “intra-group” transaction in section 45(1), a holding company contemplated in the definition of section 47(1), or a company that acquires an equity share in another company in terms of an acquisition transaction. “Reorganisation transaction” and “acquisition transaction” are also defined in section 23N(1).

Section 23N(3) provides that the amount of interest allowed to be deducted in terms of all debts owed as contemplated in section 23N(2), in respect of any year of assessment in which the “acquisition transaction” or “reorganisation transaction” is entered into and in respect of five years of assessment immediately following that years of assessment, must not exceed the sum of:

a) the amount of interest received by or accrued to the acquiring company; and

b) the highest of the amounts determined by multiplying the percentage determined under section 23M(4) (refer below) by the adjusted taxable income of the acquiring company for each of the years of assessment: (i) in which the acquisition transaction or reorganisation transaction is entered into, (ii) in which the amount of interest is incurred by that acquiring company, or (iii) immediately prior to the year of assessment contemplated in (i),

reduced by any amount of interest incurred by the acquiring company in respect of debts other than debts contemplated in section 23N(2).

The percentage in section 23M(3)(b) (refer above) must be determined in accordance with the formula:

$$A = B \times C/D$$

In which formula –
“A” represents the percentage to be determined;
“B” represents the number 40;
“C” represents the average repo rate plus 400 basis points; and
“D” represents the number 10,
but not exceeding 60 per cent of the adjusted taxable income of that acquiring company.

Please refer to our comments on section 23M for the definition of “repo rate” and “average repo rate”.

Limitations that re-characterize interest as non-deductible in specie distribution

Section 8F – hybrid debt instruments

Section 8F(2) of the Act provides that any amount of interest incurred by a company in respect of a "hybrid debt instrument" is, on or after the date that the "instrument" becomes a hybrid debt instrument, deemed for purposes of the Act to be a dividend in specie declared and paid in respect of a share by that company on the last day of the year of assessment of that company, and is not deductible in terms of the Act.

An "instrument" is defined as:

> "any form of interest-bearing arrangement or debt that is issued by –
>
> (a) a company that is a resident;
>
> (b) a company that is not a resident if the interest incurred in respect of that instrument is attributable to a permanent establishment of that company in the Republic; or
>
> (c) a company that is a controlled foreign company as contemplated in section 9D if the interest incurred in respect of that instrument must be taken into account in determining the net income of that controlled foreign company as contemplated in that section".

A "hybrid debt instrument" is defined as any "instrument" in respect of which a company owes an amount during a year of assessment if in terms of any arrangement as defined in section 80L of the Act:

> "(a) that company is in that year of assessment entitled or obliged to—
> (i) **convert** that instrument (or any part thereof) in any year of assessment to; or
> (ii) **exchange** that instrument (or any part thereof) in any year of assessment for,
> **shares** unless the market value of those shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange;
>
> (b) the obligation to pay an amount so owed on a date or dates falling within that year of assessment has been deferred by reason of that obligation being conditional upon the market value of the assets of that company not being less than the amount of the liabilities of that company; or
>
> (c) that company owes the amount to a connected person in relation to that company and is not obliged to redeem the instrument, excluding any instrument payable on demand, within 30 years from the date of issue of that instrument: Provided that, for the purposes of this paragraph, where the company has the right to—
>
> (aa) convert that instrument to; or
> (bb) exchange that instrument for,
>
> a financial instrument other than a share—
>
> (A) that conversion or exchange must be deemed to be an arrangement in respect of that instrument; and
>
> (B) that instrument and that financial instrument must be deemed to be one and the same instrument for the purposes of determining the period within which the company is obliged to redeem that instrument" (emphasis added).

> The word “convert” is not defined in the Act. Accordingly, its ordinary meaning as used in section 8F should be determined. Based on its ordinary meaning, “conversion” is the amendment of the rights of an asset in such a way as to change its nature or the exchange of one type of security for another.

Section 8F further refers to an instrument which a company can or must “exchange” for any share. The term “exchange” is not defined in section 8F and its ordinary meaning should be established. The ordinary meaning as per the Oxford Dictionary (online version) is “an act of giving one thing and receiving another (especially of the same kind) in return”.

Section 8FA – hybrid interest

In terms of section 8FA(2) of the Act, any amount that is incurred by a company in respect of interest on or after the date that the interest becomes “hybrid interest” is (1) deemed to be a dividend in specie in respect of a share that is declared and paid by that company to the person to whom that amount accrued on the last day of the year of assessment of that company during which it was incurred and (2) not deductible.

Section 8FA will therefore apply to ***inter alia:***

1) any amount that is incurred by a company in respect of “interest”;
2) on or after the date that the “interest” becomes “hybrid interest”.

Section 8FA only becomes relevant if there is “interest” and an “instrument” in terms of section 24J (refer to section 1.1 and 1.2 above).

> “Hybrid interest” in relation to any debt owed by a company in terms of an instrument means, any interest where the amount of that interest is not determined with reference to a specified rate of interest or not determined with reference to the “time value of money”.

The term “time value of money” is not defined in the Act. The dictionary meanings indicate that the term “time value of money” refers to money’s potential to grow in value over time. Such growth appears to be generally calculated with reference to an interest rate. In terms of the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2013 (which introduced section 8FA), the following is stated in respect of the rationale behind the introduction of section 8FA:

> “In terms of the anti-avoidance rules focusing on yield, the debt yield must be based on time value of money (e.g. a rate of interest) – not other factors.”

Limitations that disallow interest deductions without any re-characterization

Please refer to our above comments under section 2.1 in respect of the topic of thin capitalisation under current South African transfer pricing rules, section 23M (Limitation of interest deductions on debts owed to person not subject to tax) and section 23N (Limitation of interest in respect of reorganisation and acquisition transactions).

Part three | Implementation of the proposals in the BEPS action 4 report

Double taxation arising from limitations on deductions in respect of cross-border payments of interest are dealt with in terms of double tax agreements ("DTAs") or domestic law. In particular, South Africa will apply its domestic law (inter alia, thin capitalisation / transfer pricing rules; section 23M; section 23N) to disallow deductions of interest regardless of whether such interest is taxed in the state of residence.

Where South Africa **receives** payments of interest, it will tax such interest in terms of its domestic law and will only grant a credit to the extent that such interest has been taxed in the source state. Such credit may be claimed, by election of the taxpayer, either in terms of a DTA or domestic law (section 6quat) of the Act. If the source state denies a deduction in respect of such interest, this will not impact on the South African domestic law rules.

The OECD recommends a three tiered approach to limiting interest deductions. These are (1) a "core" maximum net interest to EBITDA ratio (2) an "optional" group ratio concession; and (3) specific targeted rules / concessions.

In respect of the core rule, entities will be able to deduct interest up to a fixed percentage of EBITDA. The OECD has provided a recommended range of acceptable ratios of between 10%- 30%.

In respect of the optional group ratio concession, the recommended group ratio rules allow an entity to claim interest deductions up to a percentage of EBITDA with that percentage determined by the group's total percentage of net third party interest expense against the group's total EBITDA

In respect of the additional targeted rules / concessions, these proposals suggest a number of targeted anti-avoidance rules designed to apply over and above the general rules. These are aimed at, inter alia, preventing interest payments to related parties in order to alter the ratios.

The extent to which these recommendations have been incorporated into South African domestic tax law is set out above, in particular, in respect of the sections dealing with thin capitalisation / transfer pricing as well as the provisions of section 23M and 23N of the Act.

The core rule has not been implemented in terms of South African domestic law. In particular, entities are not, as a general matter, restricted to a fixed percentage of EBITDA in respect of interest deductions. Instead, South Africa's thin capitalisation rules which apply only in a cross-border context use transfer pricing principles and the arm's length test in order to ascertain an appropriate interest rate in respect of related party borrowings. However, it has been noted that South Africa's corporate income tax rate is high relative to the global average and although debt capital is an important source of investment it can create opportunities for base erosion and profit shifting. In this regard, National Treasury has proposed that the existing interest limitation rule (contained in section 23M) be replaced with new rules. The most notable proposed amendments include, inter alia:

a) the tax deductibility of the net interest expense on connected person and third-party debt will be limited to 30 per cent of the entity's "tax EBITDA"; and
b) the disallowed (excessive) net interest expense may be carried forward, on a first-in-first-out basis, for a maximum period of five years. This is noted to be a fair period to allow for a smoothing of earnings.

The new interest limitation rules were originally proposed to be effective for years of assessment commencing on or after 1 January 2021. However, due to the COVID-19 pandemic, this has been postponed to at least 1 January 2022.

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